Seattle Public Utilities—Water Fund

(An Enterprise Fund of the City of Seattle)

Financial Statements and Additional Information for the Years Ended December 31, 2003 and 2002, and Independent Auditors' Report

SEATTLE PUBLIC UTILITIES—WATER FUND

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INDEPENDENT AUDITORS' REPORT

Director
Seattle Public Utilities—Water Fund
Seattle, Washington

We have audited the accompanying balance sheets of the Seattle Public Utilities—Water Fund (the "Fund") as of December 31, 2003 and 2002, and the related statements of revenues, expenses, and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis on pages 2 through 4 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Deloitte & Touche LLP

April 2, 2004

SEATTLE PUBLIC UTILITIES—WATER FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS
YEAR ENDED DECEMBER 31, 2003

The financial statements contained in this report document the financial performance of the Water Fund of Seattle Public Utilities. The revenues, expenses, assets, and liabilities of Seattle's water system are recorded in the Water Fund. The financial situation of other aspects of Seattle city government, including other utility services and general government operations, are reported elsewhere.

This section of the report summarizes the financial situation of the Water Fund, especially with respect to changes since 2002.

SUMMARY STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

The following statements of revenues, expenses, and changes in net assets present the annual surplus or deficiency of revenues over expenses (the change in net assets):

	2003	2002
Operating revenues	$129,561,327	$118,160,130
Operating expenses	97,957,673	90,862,948
Net operating income	31,603,654	27,297,182
Other expenses	(26,252,056)	(24,257,765)
Loss on Tacoma Project		(6,636,051)
Gain on sale of land rights and timber	6,752,570	
Capital and operating fees, contributions, and grants	4,748,711	6,167,043
Change in net assets	$ 16,852,879	$ 2,570,409

In 2003, the water system experienced net income of $16.9 million. Net income in 2003 was substantially higher than in 2002, due primarily to one-time events. In 2002, net income was reduced by an extraordinary loss of $6.6 million recorded on a water supply project known as the Tacoma Project. This supply project was a partnership with the City of Tacoma and several other utilities to expand the supply system of Tacoma and build a pipeline to deliver a portion of the expanded supply to the City of Seattle. Over the last decade, the City of Seattle has paid approximately $6.6 million of preliminary project costs. The City of Seattle will no longer participate in the project, so this $6.6 million was written off as an expense in 2002. Water demand in 2002 of 137 MGD (millions of gallons of water per day) and 2003 water demand of 140 MGD, respectively, are far less than the 171 MGD firm yield of the supply system, so participation in the Tacoma Project is not necessary to assure water supply in the near term. In 2003, net income included $6.7 million associated with a power transmission right-of-way easement purchased by the Bonneville Power Administration (the "BPA"). The BPA bought this easement in order to construct an electric power transmission line (Schultz-Echo Lake Transmission Line Project) through the Cedar River Watershed, which is owned by the City. Payments received from the BPA are required to be used by the City to provide increased funding for certain programs and projects in the Cedar River Watershed.

Operating revenues were $11.4 million higher in 2003 than 2002. These additional revenues were generated from a combination of rate increases effective September 16, 2002, and higher-than-expected summer demand related to especially warm and dry weather. Total operating expenses were $7.1 million higher in 2003 than 2002, of which $3.0 million was increased depreciation and amortization expenses resulting from capital investments and $1.8 million was due to increased revenue tax payments. A further $2.4 million increase in operating expense was due to a change in methodology for estimating future claims liability.

Other expenses increased by $1.7 million in interest and amortization of long-term debt. Interest expense is expected to continue to increase, reflecting substantial debt financing of the capital program. Miscellaneous revenues and interest earnings are expected to vary from year to year.

SUMMARY BALANCE SHEETS

The following summary balance sheets present the assets of the water system and show the mix of liabilities and net assets used to acquire these assets:

	2003	2002
Assets:		
Current assets	$ 30,006,838	$ 28,621,081
Noncurrent assets:		
Utility plant—net	931,598,987	867,532,552
Other	94,707,938	44,715,191
Total assets	1,056,313,763	940,868,824
Liabilities:		
Current liabilities	50,997,356	46,052,101
Noncurrent liabilities:		
Long-term debt	709,291,512	622,766,292
Other	15,524,642	8,403,057
Total liabilities	775,813,510	677,221,450
Net assets:		
Invested in capital—net of related debt	270,619,671	257,367,714
Restricted	12,987,712	4,784,991
Unrestricted	(3,107,130)	1,494,669
Total net assets	$ 280,500,253	$ 263,647,374

***Assets*—**Current assets increased by about $1.4 million, which represents an increase of $1.9 million in cash offset by small decreases in accounts receivable. Accounts receivable are generally expected to increase as rates increase. As there was no change in the rates charged between year-end 2002 and year-end 2003, the decrease in accounts receivable represents normal variation in these balances.

The $50.0 million increase in other assets includes $32.6 million in higher 2003 year-end construction fund cash balances, $5.5 million in deferred charges which include conservation cost and other costs, $5.4 million in the Rate Stabilization Fund, and $6.7 million in revenues associated with the Bonneville easement which are restricted for certain mitigation activities. Construction fund cash balances vary from year to year depending upon the amount of new debt issued and the level of debt-funded capital investment. Beginning in 2003, the Water Fund is deferring a portion of current revenues in the Rate

Stabilization Fund to buffer financial performance when adverse supply or demand conditions reduce water sales. Significant capital spending of $93.6 million increased net utility plant (including work in progress) by $64 million. Of this, $36.5 million was construction of a new treatment plant on the Cedar River source of supply that is expected to be complete in 2004. The remaining $57.1 million in capital acquisitions include pipeline, conservation, and distribution system improvements, including $8.2 million in projects related to the Cedar River Habitat Conservation Plan. Large capital investments are expected to continue in the mid-term. Over the next five years, the adopted capital improvement program totals $468.8 million, and includes $2.1 million to complete the treatment plant on the Cedar River, $18.9 million for investments related to the Cedar River Habitat Conservation Plan, and $117.7 million to bury above-ground reservoirs.

***Liabilities*—**Current liabilities increased by about $4.9 million, of which $4.4 million is related to interest and principal on debt. This increase in debt service payments reflects ongoing debt financing of a substantial capital program. A decrease in accounts payable of $1.3 million was offset by a deferral of $1.4 million in wholesale revenues associated with claims.

***Long-Term Debt*—**In 2003, $271.3 million in revenue bonds was issued to finance the water system capital program and refinance the $175.8 million in outstanding 1993 revenue bonds. The 2003 bond issue was insured and rated AAA by Moody's and AAA by Standard & Poor's. The water system's underlying bond rating continues to be Aa2 and AA respectively, with a stable outlook. This bond issue, net of the bonds retired in 2003, is responsible for the $86.5 million increase in the water system's long-term debt liability. The water system expects to continue to finance a large portion of its capital program with revenue bonds in the near term.

SEATTLE PUBLIC UTILITIES—WATER FUND

BALANCE SHEETS
DECEMBER 31, 2003 AND 2002

ASSETS	2003	2002
CURRENT ASSETS:		
Cash and equity in pooled investments	$ 5,876,299	$ 3,990,918
Accounts receivable, net of allowances for doubtful accounts of $595,450 and $148,268	9,344,760	10,528,750
Unbilled revenues	6,883,190	7,076,983
Current portion of notes and contracts receivable	147,314	91,618
Due from other City funds	1,769,961	724,880
Due from other governments	1,200,377	1,366,745
Materials and supplies inventory	4,771,476	4,827,185
Prepayments and other	13,461	14,002
	30,006,838	28,621,081
RESTRICTED ASSETS:		
Bond Parity Account—cash and equity in pooled investments	3,112,350	3,052,300
Construction Fund:		
Cash and equity in pooled investments	27,860,271	19,430,360
Investments	24,193,879	–
Vendor deposits—cash and equity in pooled investments	135,534	676,460
Interest receivable	241,702	–
Rate Stabilization Fund—cash and equity in pooled investments	5,370,953	–
BPA account—cash and equity in pooled investments	6,690,100	–
	67,604,789	23,159,120
DEFERRED CHARGES AND OTHER:		
Unamortized bond issue costs—net	4,845,746	4,630,763
Notes and contracts receivable	465,324	710,013
Deferred conservation costs—net	16,018,280	13,273,045
Other deferred charges—net	5,773,799	2,942,250
	27,103,149	21,556,071
UTILITY PLANT—At original cost:		
Plant in service—excluding land	1,058,828,931	972,632,068
Less accumulated depreciation	(304,583,401)	(278,491,430)
	754,245,530	694,140,638
Construction in progress	163,422,803	159,569,204
Land and land rights	13,656,142	13,548,198
Nonoperating property—net of accumulated depreciation	274,512	274,512
	931,598,987	867,532,552
TOTAL	$1,056,313,763	$940,868,824

See notes to financial statements.

LIABILITIES	2003	2002
CURRENT LIABILITIES:		
Accounts payable	$ 10,014,131	$ 11,309,675
Accrued payroll and payroll taxes payable	1,672,121	1,357,254
Compensated absences payable	338,765	481,700
Due to other City funds	2,399,169	2,879,828
Interest payable	11,131,724	7,925,208
Taxes payable	497,287	387,231
Claims payable	1,031,509	645,032
Revenue bonds due within one year	21,600,000	20,363,956
Public works trust loan due within one year	118,217	118,217
Deferred credits and other	2,194,433	584,000
	50,997,356	46,052,101
REVENUE BONDS:		
Revenue bonds—due serially	731,485,000	654,130,000
Less revenue bonds due within one year	(21,600,000)	(20,363,956)
Less bond discount—net	(2,055,048)	(5,379,401)
Plus bond premium—net	13,295,635	561,730
Less deferred charges on advance refunding	(11,834,075)	(6,182,081)
	709,291,512	622,766,292
NONCURRENT AND OTHER LIABILITIES:		
Compensated absences payable—noncurrent	3,074,059	2,678,722
Public works trust loan	1,063,950	1,182,167
Claims payable	3,997,266	1,963,594
Environmental liability	1,300,000	1,225,633
Vendor deposits payable	135,534	676,460
Deferred credits—Rate Stabilization Fund	5,370,953	
Other	582,880	676,481
	15,524,642	8,403,057
Total liabilities	775,813,510	677,221,450
NET ASSETS:		
Invested in capital assets—net of related debt	270,619,671	257,367,714
Restricted	12,987,712	4,784,991
Unrestricted	(3,107,130)	1,494,669
Total net assets	280,500,253	263,647,374
TOTAL	$1,056,313,763	$940,868,824

SEATTLE PUBLIC UTILITIES—WATER FUND

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS YEARS ENDED DECEMBER 31, 2003 AND 2002

	2003	2002
OPERATING REVENUES:		
Direct service, net of amounts transferred to Rate Stabilization Fund of $5,349,004 and $-0-	$ 86,882,561	$ 80,846,459
Wholesale	41,105,938	35,787,617
Other	1,572,828	1,526,054
Total operating revenues	129,561,327	118,160,130
OPERATING EXPENSES:		
Resource management	7,560,802	8,312,131
Field operations	25,489,519	24,232,845
Engineering services	3,160,008	2,623,295
Customer services	7,991,308	8,075,049
General and administrative	12,068,928	10,652,161
City business and occupation taxes	8,942,200	7,867,504
Other taxes	4,621,600	3,928,747
Depreciation and amortization	28,123,308	25,171,216
Total operating expenses	97,957,673	90,862,948
NET OPERATING INCOME	31,603,654	27,297,182
OTHER INCOME (EXPENSES):		
Investment and interest income	809,417	1,147,940
Interest expense	(25,948,044)	(23,952,159)
Amortization of debt expenses	(956,899)	(1,278,400)
Gain on sale of land rights and timber	6,752,570	
Loss on Tacoma Project		(6,636,051)
Other	(156,530)	(175,146)
Total other expenses—net	(19,499,486)	(30,893,816)
CAPITAL AND OPERATING FEES, CONTRIBUTIONS, AND GRANTS	4,748,711	6,167,043
CHANGE IN NET ASSETS	16,852,879	2,570,409
NET ASSETS:		
Beginning of year	263,647,374	261,076,965
End of year	$280,500,253	$263,647,374

See notes to financial statements.

SEATTLE PUBLIC UTILITIES—WATER FUND

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2003 AND 2002

	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from customers	$ 130,249,390	$ 116,015,472
Cash paid to suppliers and employees	(47,323,952)	(49,827,243)
Cash paid for taxes	(14,051,616)	(10,994,246)
Net cash provided by operating activities	68,873,822	55,193,983
CASH FLOWS FROM NONCAPITAL AND RELATED FINANCING ACTIVITIES:		
Operating grants received	172,822	–
Receipts from sale of land rights and timber	6,752,570	–
Other	(156,530)	(175,147)
Net cash provided by (used in) noncapital and related financing activities	6,768,862	(175,147)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Proceeds from the sale of bonds	282,083,277	64,923,517
Principal payments on revenue bonds	(193,965,000)	(18,360,000)
Debt issuance costs	(1,528,895)	(230,943)
Principal payment on public works trust loan	(118,217)	(118,217)
Acquisition and construction of utility plant and additions to deferred assets	(91,254,726)	(90,409,986)
Interest paid	(29,913,377)	(31,319,372)
Capital fees, contributions, and grants	4,575,889	6,167,043
Net cash used in capital and related financing activities	(30,121,049)	(69,347,958)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(24,435,582)	–
Proceeds from sale of investments		33,578,241
Interest received on investments	809,416	1,147,938
Net cash (used in) provided by investing activities	(23,626,166)	34,726,179
NET INCREASE IN CASH AND EQUITY IN POOLED INVESTMENTS	21,895,469	20,397,057
CASH AND EQUITY IN POOLED INVESTMENTS:		
Beginning of year	27,150,038	6,752,981
End of year	$ 49,045,507	$ 27,150,038

(Continued)

SEATTLE PUBLIC UTILITIES—WATER FUND

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2003 AND 2002

	2003	2002
RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net operating income	$ 31,603,654	$ 27,297,182
Adjustments to reconcile net operating income to net cash provided by operating activities:		
Depreciation and amortization	28,123,308	25,171,216
Changes in operating assets and liabilities:		
Accounts receivable	1,183,990	(1,941,087)
Unbilled revenues	193,793	(632,050)
Due from other City funds	(1,045,081)	930,312
Due from other governments	166,369	(588,446)
Materials and supplies inventory	55,709	(318,450)
Current portion of notes and contracts receivable	(55,696)	(5,003)
Prepayments and other	541	(2,143)
Notes and contracts receivable	244,689	91,618
Environmental liability	74,367	(74,367)
Vendor deposits payable	(540,926)	(269,115)
Accounts payable	(635,495)	4,824,926
Accrued payroll and payroll taxes payable	314,867	33,714
Compensated absences payable	252,401	(80,380)
Due to other City funds	(480,659)	(16,618)
Claims payable	2,420,149	721,402
Deferred credits—net	5,370,953	
Other liabilities	1,626,889	51,272
Total adjustments	37,270,168	27,896,801
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 68,873,822	$ 55,193,983
NONCASH TRANSACTIONS—Decrease in fair market value on investments	$ (75,252)	$ –

See notes to financial statements. (Concluded)

1. OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Operations—The City of Seattle, Seattle Public Utilities—Water Fund (the "Fund") is a public utility enterprise fund of the City of Seattle (the "City"). On January 1, 1997, the City created Seattle Public Utilities ("SPU"), which brought together under one administrative umbrella the Water, Solid Waste, and Drainage and Wastewater functions of the City as well as certain engineering functions. The Fund (as well as the other funds) remains separate for accounting purposes. SPU receives certain services from other departments and agencies of the City, including some that are normally considered to be general and administrative. The Fund is charged a share of these costs and additionally pays a business and occupation tax to the City's General Fund. Water services provided by the Fund to other City departments and agencies are billed at rates prescribed by City ordinances. Under direction of the Seattle City Council, no charges are made to the City for water services for public fire protection.

The utility billing function is co-managed by both SPU and Seattle City Light ("SCL"). SPU provides customer service through the call center and walk-in center. SCL operates and manages the billing system, Combined Customer Services System ("CCSS"). In 2003, both SPU and SCL billed and reimbursed each other for these services. Within SPU, the costs and reimbursements were shared among its three utility funds (Water, Drainage and Wastewater, and Solid Waste). The Fund received reimbursements related to the call center and walk-in center of $1,124,323 in 2003 and paid $911,091 for CCSS services. In 2002, SPU and SCL agreed to exchange their services with each other, and as a result, no billing and reimbursement were made. The Fund provided services to SCL with a cost of $1,033,601 and in return the Fund received services from SCL with a cost of $994,998 in 2002.

The Fund is subject to regulation by the City and the state of Washington. Service rates are authorized by ordinances passed by the City Council. Accounting policies and financial reporting are regulated by the Washington State Auditor's Office, Division of Municipal Corporations and conform to accounting principles generally accepted in the United States of America as applied to governmental units. The Governmental Accounting Standards Board ("GASB") is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. The Fund has chosen to apply all pronouncements and interpretations issued by the GASB, as well as those issued by the Financial Accounting Standards Board on or before November 30, 1989, except when they conflict with the GASB.

Basis of Accounting—The Fund is accounted for on a flow of economic resources measurement focus. Its financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as applied to governmental units using the accrual basis of accounting. With the flow of economic resources measurement focus, all assets and liabilities associated with the Fund's operations are included on the balance sheets. The operating statements present increases (revenues) and decreases (expenses) in total net assets.

Revenues—The Fund provides water service to wholesale and retail customers and recognizes revenue when such service is provided. Wholesale customers ("Purveyors") are under contract with the Fund and rates are set based on cost allocation criteria stipulated in the contracts.

Service rates for all customers are authorized by ordinances passed by the Seattle City Council. Billings are made to customers monthly or bimonthly. Revenues for water sold to customers between the last billing date and the end of the year are estimated and accrued in the accompanying financial statements.

***Utility Plant*—**Utility plant is stated at cost or, if contributed, at fair value at the date of contribution. Costs include direct material, labor, and indirect costs such as engineering, supervision, payroll taxes, pension benefits, and interest relating to the financing of projects under construction. The cost of current repairs and maintenance is charged to expense, while the cost of replacements and betterments is capitalized. The Fund's policy is to capitalize assets with a cost of $5,000 or more. At the time property is retired and removed from service, the original cost of the property, together with removal cost less salvage value, is charged to the depreciation reserve.

***Depreciation*—**Plant in service is depreciated on the straight-line method, using composite rates based on estimated lives as follows:

Earthen source of supply developments	100 years
Transmission and distribution reservoirs, tanks, and mains	50 to 100 years
Pumps, wells, and treatment facilities	15 to 33 years
Buildings, fixtures, and equipment	3 to 50 years

It is the Fund's policy to begin recording depreciation in the year following acquisition and to record a full year's charge in the year of disposition.

***Construction in Progress*—**Capitalizable costs incurred on projects which are not in use or ready for use are held in construction in progress. When the asset is ready for use, related costs are transferred to utility plant. Upon determining that a project will be abandoned, the related costs are charged to expense.

***Deferred Conservation Costs*—**Conservation program costs that result in long-term benefits and reduce or postpone other capital expenditures are deferred and amortized over their expected useful lives of 10 years, commencing when each program is in place. Costs of administering the overall program are expensed as incurred.

***Other Deferred Charges*—**Other deferred charges primarily include the easement and right of way, plans and studies, and environmental related charges. Other deferred charges at December 31, 2003 and 2002, were $5,773,799 and $2,942,250, respectively.

***Environmental Liability Cleanup Costs*—**In the ordinary course of conducting its business, the Fund incurs liabilities related to the cleanup of certain environmental contaminants. The Fund's policy is to recognize the expense associated with the cleanup over those periods in which the costs are recovered through rates.

***Rate Stabilization Fund*—**The Rate Stabilization Fund was established by the City Council to reduce year-to-year variation in rates. Amounts deposited into the Rate Stabilization Fund are excluded from the statement of revenues, expenses, and changes in net assets in accordance with Statement of Financial Accounting Standards ("SFAS") No. 71, *Accounting for the Effects of Certain Types of Regulations*. The Fund deposited $5,349,000 into the Rate Stabilization Fund in 2003 and $-0- in 2002, as directed by Council ordinance. The Rate Stabilization Fund is included in the "Rate Stabilization Account" identified in Water Fund bond covenants. These covenants provide that withdrawals and deposits from the "Rate Stabilization Account" shall augment or reduce adjusted net revenue available for the payment of debt service.

***BPA Account*—**In 2003, the Bonneville Power Administration ("BPA") purchased an easement in the amount of $6.0 million from the Water Fund to construct a power transmission line through the Cedar River Watershed. This amount is included in gain on sale of land rights and timber in the statements of revenues, expenses, and changes in net assets. This $6.0 million, together with $657,149 in timber sales related to the easement, were deposited into the BPA account and are classified as restricted assets. At December 31, 2003, the cash balance in the BPA account was $6.7 million. Water Fund bond covenants provide that withdrawals and deposits from a "Rate Stabilization Account" shall augment or reduce adjusted net revenue available for the payment of debt service. Moneys in the BPA account assets are considered a portion of the "Rate Stabilization Account" described in these covenants. The Water Fund will recognize the revenues deposited in the BPA account in the calculation of adjusted net revenues available for the payment of debt services as they are withdrawn to fund certain activities in the Cedar River Watershed.

***Timber Sales*—**The Fund occasionally contracts with outside timber purchasers to harvest timber owned within its watershed and nonoperating properties. Revenue is recognized based on terms of the harvesting contract. The cutting schedules and associated revenues and expenses are primarily determined by market and other factors. Income arising from timber operations may vary significantly from year to year. During 2003, revenue from timber sales were $859,370, including $657,149 of timber sales related to the BPA easement/timber sale agreement. No timber sales were made in 2002.

***Compensated Absences*—**Employees earn vacation based on their date of hire and years in service, and may accumulate earned vacation up to a maximum of 480 hours. Unused vacation at retirement or normal termination is considered vested and payable to the employee. Earned but unused vacation is accrued as a liability of the Fund.

Employees also earn up to 12 days of sick leave per year and may accumulate sick leave balances without limit. Employees are paid 25% of the value of unused sick leave upon retirement. They are not paid for unused sick leave if they leave before retirement. The Fund records a liability for estimated sick leave payments.

***Taxes*—**The Fund is charged a business and occupation tax by the City at a rate of 10% of Fund revenue, net of certain credits and certain revenues including all wholesale revenues. In addition, the Fund paid a 5.029% public utility tax to the state on a certain portion of revenues. The Fund is also taxed by the state under the business and occupation tax at the rate of 1.5% in 2003 and 2002.

***Inventory*—**The Fund values its inventory based on a moving average method. The most recent total cost of an inventory item is divided by the total units of the item that remain in the inventory to determine the moving average cost of the item. The moving average cost is then applied to all the units of the inventory item.

***Net Assets*—**There are three components of net assets: invested in capital—net of related debt, restricted net assets, and unrestricted net assets. Invested in capital assets includes utility plant and net unamortized bond issuance costs. Restricted net assets as of December 31, 2003, consists of unspent bond proceeds—net of related debt, deferred conservation costs, other deferred charges—net of related debt, the Rate Stabilization Fund—net of the related deferred credit, and the BPA account. Restricted net assets as of December 31, 2002, consists of deferred conservation costs and other deferred charges—net of related debt, and unspent bond proceeds—net of related debt.

***Other Revenues and Expenses*—**This includes the nonoperating revenues and expenses that arise from transactions not related directly to the major income-earning operations of the utility and are of a recurring nature. Major items are investment and interest income, interest expense, and amortization of debt expenses.

***Arbitrage Rebate Requirement*—**The Fund is subject to the Internal Revenue Service Code, Section 148(f), related to its tax-exempt revenue bonds. The Internal Revenue Service Code requires that earnings on gross proceeds of any revenue bonds, which are in excess of the amount prescribed, will be rebated to the Internal Revenue Service. As such, the Fund would record such rebate as a liability. No liability was recorded December 31, 2002 or 2003.

***Accounting Changes*—**In March 2003, the GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures*. This statement establishes and modifies disclosure requirements related to investment risks: credit risk (including custodial credit risk and concentrations of credit risk), interest rate risk, and foreign currency risk. This statement also establishes and modifies disclosure requirements for deposit risks: custodial credit risk and foreign currency risk. The requirements of this statement are effective for the Fund's financial statements for periods beginning after June 15, 2004 (January 1, 2005). The Fund is in the process of determining the impact of this standard on the Fund's financial statements.

GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This statement also clarifies and establishes accounting requirements for insurance recoveries. The Fund is in the process of determining the impact of this standard on the Fund's financial statements.

***Use of Estimates*—**The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the financial statements. Estimates and assumptions are used to record unbilled revenues, allowance for doubtful accounts, accrued sick leave, environmental liabilities, and other contingencies. Changes in these estimates and assumptions may have a material impact on the financial statements.

***Reclassifications*—**Certain reclassifications have been made to prior year balances to provide a presentation consistent with the current year.

2. CASH AND EQUITY IN POOLED INVESTMENTS AND INVESTMENTS

The City's Department of Finance invests all temporary cash surpluses for City departments. This department may, at various times, invest these surpluses in certificates of deposit issued by Washington State depositories that participate in a state insurance pool, U.S. Treasury and agency securities, prime bankers' acceptances trading in the secondary market, and repurchase or reverse-repurchase agreements with primary dealers that use authorized securities as collateral. Delivery of collateral on the underlying securities is required on all repurchase agreement transactions. The Fund is allocated interest income by the City.

It is the City's policy that all investments of the Fund, except repurchase or reverse-repurchase agreements, be held by banks or trust companies as agents of the City and in the City's name.

The first $100,000 of bank deposits are federally insured. The Washington State Public Deposit Protection Commission ("PDPC") collateralizes deposits in excess of $100,000. The PDPC is a multiple financial institution collateral pool. There is no provision for the PDPC to make additional pro rata assessments if needed to cover a loss. Therefore, the PDPC protection is of the nature of collateral, not of insurance.

The City considers highly liquid, short-term investments with original maturities of three months or less to be cash equivalents. The cash pool operates like a demand deposit account in that all agencies, including the City, may deposit cash at any time and can also withdraw cash out of the pool without prior notice or penalty. Accordingly, the statements of cash flows reconcile to cash and equity in pooled investments plus the cash held in escrow for vendors. Securities with maturities exceeding three months at the time of purchase are reported at fair value on the balance sheets; the net increase (decrease) in the fair value of those investments is reported as part of investment income.

Capital expenditures are initially funded by the Operating Fund, which is subsequently reimbursed by the Construction Fund.

Investments are reported at fair value based on quoted market prices for those or similar securities and are as follows at December 31, 2003:

U.S. government securities	$ 24,193,879

There were no investments as of December 31, 2002.

3. NOTES AND CONTRACTS RECEIVABLE

Other receivables are composed of the following as of December 31:

	2003	2002
Water main assessments	$ 296,458	$ 357,378
Land sales receivable	151,510	233,839
Richmond Beach surcharge	164,670	210,414
	612,638	801,631
Less current portion	(147,314)	(91,618)
Total other receivables, net of current portion	$ 465,324	$ 710,013

4. UTILITY PLANT

Utility plant consists of the following as of December 31:

	2002	Additions and Transfers In	Retirements and Transfers Out	2003
Equipment	$784,447,762	$ 59,551,407	$ –	$ 843,999,169
Buildings, fixtures, and grounds	135,150,251	24,531,983		159,682,234
Computer applications, surveys, and other	53,034,055	2,113,473		55,147,528
Total plant in service—excluding land	972,632,068	86,196,863		1,058,828,931
Less accumulated depreciation	(278,491,430)	(26,091,971)		(304,583,401)
	694,140,638	60,104,892		754,245,530
Construction in progress	159,569,204	100,826,147	(96,972,548)	163,422,803
Land and land rights	13,548,198	107,944		13,656,142
Nonoperating property—net of accumulated depreciation	274,512			274,512
Utility plant—net	$867,532,552	$161,038,983	$ (96,972,548)	$ 931,598,987

During 2003 and 2002, the Fund capitalized interest costs relating to construction of $7,171,850 and $7,213,226, respectively.

5. REVENUE BONDS

At December 31, revenue bonds consist of the following:

	2003			2002		
	Long-Term	Short-Term	Total	Long-Term	Short-Term	Total
2003 Water System Revenue Bonds, 4.625% to 6.00%, due through 2033, insured by a third-party insurer	$244,160,000	$12,660,000	$256,820,000	$ –	$ –	$ –
2002 A&B Water System Revenue Bonds, rates averaging 1.02% in 2003, due through 2032, insured by a third-party insurer	62,600,000	1,200,000	63,800,000	63,841,044	1,158,956	65,000,000
2001 Water System Revenue Bonds, 4.50% to 5.00%, due through 2031, insured by a third-party insurer	52,525,000		52,525,000	52,525,000		52,525,000
1999B Water System Revenue Bonds, 5.00% to 6.00%, due through 2029, insured by a third-party insurer	102,640,000	1,960,000	104,600,000	104,600,000	1,875,000	106,475,000
1999A Water System Revenue Bonds, 4.00% to 5.375%, due through 2029, insured by a third-party insurer	91,480,000	1,840,000	93,320,000	93,320,000	1,765,000	95,085,000
1998 Water System Revenue Bonds, 4.5% to 5.0%, due through 2027, insured by a third-party insurer	71,175,000	1,630,000	72,805,000	72,805,000	1,560,000	74,365,000
1997 Water System Revenue Bonds, 5.375% to 5.625%, due through 2026, insured by a third-party insurer	45,805,000	1,110,000	46,915,000	46,915,000	1,065,000	47,980,000
1995 Water System Revenue Bonds, variable rates averaging 0.92% in 2003, due through 2025, insured by a third-party insurer	39,500,000	1,200,000	40,700,000	40,700,000	1,100,000	41,800,000
1993 Water System Revenue Bonds, 4.7% to 5.5%, due through 2023, insured by a third-party insurer				159,060,000	11,840,000	170,900,000
	$709,885,000	$21,600,000	$731,485,000	$633,766,044	$20,363,956	$654,130,000

In May 2003, the Fund issued $271,320,000 of Water System Revenue and Refunding Bonds with varying annual principal payments due in 2003 and continuing through 2033, with interest ranging from 4.625% to 6%. A portion of the proceeds from the issuance, in the amount of $175,834,697, was used to refund the 1993 Water System Bonds. As a result of the refunding, the Fund reduced its total debt service requirements by $20.6 million, which resulted in an economic gain (difference between the present value of the debt service payments on the old and new debts) of $13.8 million. A deferred expense (the difference between the cost to refund outstanding debt and the carrying value of bonds refunded) of $13,036,017 is being amortized over the lives of the refunded bonds using the effective rate interest method.

The 1995 Water System Revenue Bonds and the 2002 Water System Revenue Bonds are variable rate obligations. The Fund has secured the services of remarketing agents responsible for remarketing the bonds at regular intervals on the open market. The Fund pays actual market interest costs and a fee for remarketing services. The bonds are currently remarketed weekly, though the Fund retains the ability to cause the bonds to be remarketed at other intervals.

Proceeds of the revenue bonds are being used to finance certain capital improvement projects and conservation programs for the Fund.

Future principal and estimated interest payments for revenue bonds are as follows:

Years Ending December 31	Principal	Interest	Total
2004	$ 21,600,000	$ 33,069,440	$ 54,669,440
2005	20,540,000	31,972,974	52,512,974
2006	20,330,000	31,164,927	51,494,927
2007	18,180,000	30,362,561	48,542,561
2008	19,255,000	29,610,313	48,865,313
2009 – 2013	110,305,000	134,940,811	245,245,811
2014 – 2018	139,010,000	108,726,892	247,736,892
2019 – 2023	172,445,000	73,667,479	246,112,479
2024 – 2028	143,420,000	35,274,497	178,694,497
2029 – 2033	66,400,000	8,240,388	74,640,388
	$731,485,000	$517,030,282	$1,248,515,282

Water System Revenue Bonds contain certain financial covenants, the most significant of which requires the Fund to maintain adjusted net revenue to provide for debt service coverage on the bonds and a reserve for the payment of annual debt service. The Fund must maintain adjusted net revenue of not less than 125% of actual annual senior lien debt service. Adjusted net revenues remaining after senior lien debt service has been paid must not be less than 125% of annual junior lien debt service. In 2003, adjusted net revenue was 164% of senior lien debt service, and adjusted net revenue available after senior lien debt service was paid was 902% of junior lien debt service. The Fund has obtained reserve insurance policies to meet its reserve requirements. Net revenues available for debt service for the year ended December 31, 2003, is determined as follows:

Change in net assets	$ 16,852,879
Add:	
City occupation tax	8,942,200
Depreciation and amortization	28,123,308
Interest on revenue bonds	33,119,893
Amortization of debt expenses and loss	956,900
Claims and damages not paid in 2003	2,420,149
Investment fair value adjustment	578,147
	90,993,476
Less:	
Capitalized interest	7,171,850
Gain on sale of land rights and timber—BPA Account	6,657,149
Adjusted net revenue available for debt service	$ 77,164,477
Senior debt service requirement (cash basis)	$ 47,121,632
Senior lien coverage percentage	164 %
Adjusted net revenue available for junior lien debt service	$ 30,042,845
Junior lien debt service requirement (cash basis)	3,332,565
Junior lien coverage percentage	902%

6. PUBLIC WORKS TRUST LOAN

During 1993, the Fund entered into an agreement to borrow up to $2,220,000 from the Washington State Department of Community Development under its Public Works Trust Loan Program for the construction of certain capital improvements. Amounts borrowed under the agreement accrue interest at 1% per annum and are to be repaid in 19 equal annual installments, plus interest. As of December 31, 2003 and 2002, the Fund owed $1,182,167 and $1,300,384, respectively.

7. ENVIRONMENTAL LIABILITY

The Fund has recorded a $1,300,000 liability for future environmental cleanup costs related to lead-based paint and arsenic contamination surrounding several standing water tanks as well as expected remediation efforts associated with underground fuel tank replacements. The liability is included in other long-term liabilities on the balance sheet. The total cost is expected to be recovered through rates over an estimated 14-year period.

8. RETIREMENT PLANS

Pension Costs**—**All permanent Fund employees are eligible to participate in the Seattle City Employees' Retirement System (the "System"), a cost-sharing public employee retirement system operated by the City. Benefits vest after five years of covered service. City employees may retire after 30 years of service regardless of age; after age 52, with 20 or more years of service; after age 57, with 10 or more years of service; and after age 62, with five or more years of service. The System also provides death and disability benefits. These benefit provisions and all other requirements are established by City ordinances.

City employees are required to contribute 8.03% of their annual base salaries to the System. The City's contribution rate was 8.03% as of January 1, 2003 and 2002. Employer rates are established by the City Council on a biannual basis. The Fund's contributions to the System for the years ended December 31, 2003, 2002, and 2001, were $2,752,020, $2,665,945, and $2,461,551, respectively. The Fund's contribution in 2003 represents its full liability to the System.

The System issues stand-alone financial statements, which may be obtained by writing to the Seattle City Employees' Retirement System, 801 Third Avenue, Suite 300, Seattle, Washington, 98104; telephone: (206) 386-1292.

Employer contributions for the City are as follows (dollars in millions):

Year Ended December 31	City Required Contribution	City Actual Contribution	Percentage Contributed
2001	$ 32.5	$ 32.5	100 %
2002	35.2	35.2	100
2003	34.2	34.2	100

Actuarial data and assumptions:	
Valuation date	January 1, 2002
Actuarial cost method	Entry age
Amortization method	Level percent
Remaining amortization period	33.7 years
Amortization period	Open
Asset valuation method	Market
Investment rate of return	8.00%
Projected general wage inflation	4.50%
Postretirement benefit increases	0.67%

Schedule of funding progress (dollars in millions):

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liabilities (AAL) — Entry Age (b) (1)	Unfunded AAL (UAAL) (b-a) (2)	Funded Ratio (a/b)	Covered Payroll (c) (3)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
1/1/2000	$ 1,582.7	$ 1,403.1	$ (179.6)	112.8 %	$ 370.4	(48.5)%
1/1/2001	1,493.1	1,490.3	(2.8)	100.2	383.7	(0.7)
1/1/2002	1,383.7	1,581.4	197.7	87.5	405.1	48.8

(1) Actuarial present value of benefits less actuarial present value of future normal costs based on entry age actuarial cost method
(2) Actuarial accrued liabilities less actuarial value of assets
(3) Covered payroll includes compensation paid to all active employees on which contributions

The City now performs an actuarial analysis on a bi-annual basis and expects to perform the next actuarial analysis as of January 1, 2004.

***Deferred Compensation*—**The City offers all of its employees a deferred compensation plan (the "Plan") created in accordance with Internal Revenue Code ("IRC") Section 457. The Plan permits employees to defer a portion of their salaries until future years. The deferred compensation is paid to employees upon termination, retirement, death or unforeseen emergency.

The Plan is an eligible deferred compensation plan under Section 457 of the IRC of 1986, as amended, and a trust exempt from tax under IRC Sections 457(g) and 501(a). The Plan is operated for the exclusive benefit of participants and their beneficiaries. No part of the corpus or income of the trust shall revert to the City or be used for, or diverted to, purposes other than the exclusive benefit of participants and their beneficiaries.

The Plan is not reported in the financial statements of the City or the Fund.

It is the opinion of the City's legal counsel that the City has no liability for investment losses under the Plan. Under the Plan, participants select investments from alternatives offered by the Plan Administrator, who is under contract with the City to manage the Plan. Investment selection by a participant may be changed from time to time. The City does not manage any of the investment selections. By making the selection, participants accept and assume all risks inherent in the Plan and its administration.

9. RISK FINANCING LIABILITIES

The City and the Fund are self-insured for certain losses arising from personal and property damage claims by third parties and for casualty losses to the Fund's property. Liabilities for identified claims and claims incurred but not reported have been recorded by the Fund.

For 2003 and 2002, liabilities for workers' compensation claims are discounted over a 15-year period at the City's rate of return on investments, 3.16% and 4.24%, respectively. Claims expected to be paid within one year were $1,031,509 and $645,032 at December 31, 2003 and 2002, respectively. The schedule below represents the changes in the liability for workers' compensation claims and other claims (risk-financing liabilities) as of December 31:

	2003	2002
Beginning liability	$2,608,626	$1,887,224
Payments	(1,427,891)	(516,300)
Incurred claims and changes in estimates	3,848,040	1,237,702
Ending liability	$5,028,775	$2,608,626

10. COMMITMENTS AND CONTINGENCIES

Seattle Public Utilities has prepared a comprehensive environmental management plan for its Cedar River Watershed. The purpose of the Habitat Conservation Plan ("HCP") is to protect all species of concern that may be affected by the operations of Seattle Public Utilities and City Light in the Cedar River Watershed, while allowing the City to continue to provide high quality drinking water to the region. The federal government has accepted the HCP. The total cost of implementing the HCP is expected to be $90 million (in 2002 dollars) over a period of 50 years. Expenditures are expected to be funded from a combination of operating revenues and debt.

The Fund has negotiated an agreement relating to compliance with the Surface Water Treatment Rule on its Cedar River supply system, which requires it to evaluate ozonation and filtration, and recommend changes to current treatment. A recommendation for ozonation compatible with filtration was provided to the Washington State Department of Health in November 1995, and approved in January 1996. The ozonation facility is under construction and expected to cost approximately $100 million, of which $2.1 million is expected to be paid in 2004. The facility is expected to be operational in 2004. Expenditures are expected to be funded from a combination of operating revenues and debt.

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